GREENLEAF TRUST

Perspectives

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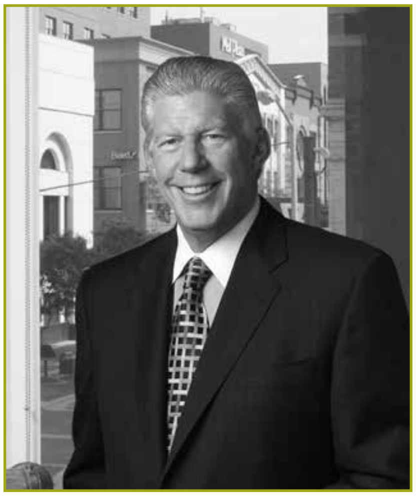

William D. Johnston
Chairman, Greenleaf Trust

Economic and Market Commentary

September has developed a reputation of being a tough month for stocks and the statistics justify that perception to a degree. Over the last one hundred years, equities lost value in September nearly 60% of the time and have a -0.90% return for the duration of the record keeping time frame. Investors, of course, want to know why September proves to be disappointing and there are countless theories but none compelling enough to gather support. This September is certainly starting off with ingredients that if combined would make a strong case for lower equity prices. The key element is of course how much lower. Technicians, those who trade rather than invest, are very nervous and becoming increasingly bearish in their view of the now four and a half year old bull market in stocks and will likely see market rallies as opportunities to sell. Fundamental investors, those with a longer term horizon and a belief that owning equities is driven by earnings, continue to feel that there is more left to the current secular bull market yet they too are increasing their caution but for different reasons. I have often said that we cannot predict short term trading ranges and will not try to do so here, but we can examine the data and form an opinion on where we are most likely headed. To do so it makes sense to view September and for that matter the rest of the year through the lens of the economy, tapering by the Fed, valuations and geo-political stability (Syria).

ECONOMY

We have maintained through the recovery that incremental improvement over time will create tangible results and July's manufacturing data along with the second quarter's GDP revisions may be the beginning of a trend of consistently higher growth expectations. Don't get real excited, higher is better than the same or lower, yet we are still talking in the range of 3% growth rather than the 2% level we have been experiencing. The one percent difference is important as it creates more jobs and increases employment stability. While consistent job creation of around 200,000 per month won't change the unemployment rate a great deal, it

Commentary, continued

will positively impact the employment prospects for those entering the workforce. It is an unfortunate fact that long term unemployed find it much more difficult to regain employment than those who are just entering the workforce. As we look at the data for employment we see stability in average wage at $24.00 dollars per hour and a slight gain in average hours worked. The employment cost index remained the same and productivity grew over the first quarter. The Purchasing Managers Index rose by 4.5% to 55.4%. You may recall we had been concerned about the PMI hovering below 50% in the first quarter. We now have two months in a row where the PMI has increased and July's rate of growth is the fastest we have seen in some time. Other faster rates of growth on the manufacturing side are in new orders, production, employment, exports and imports. Inventories as well as customer portfolios shrunk indicating a need to increase them as this trend has remained consistent for some time. When inventories of production components as well as finished goods are low, future demand for goods necessary to fill the demand of a slightly higher GDP growth rate can cause an increase in economic activity. The degree of the jump in the PMI index caught many analysts off guard and, combined with the second quarter GDP revision, led to an almost universal assumption that the Fed will begin tapering at their September FOMC meeting. The markets have not digested the tapering discussion well and the most recent pull back in the stock market in late June through early July is an indication that stocks will be susceptible to any extreme change of course decision by the Fed. The markets inability to deal rationally with the notion of tapering tells us how much some think the growth in the equity market has been fueled more by very low interest rates than by the earnings growth of publicly traded companies. While the lack of competition for the investor dollar has helped the equity market it is not the only reason for the market's advance. Short term movement in the market is always amplified by herd mentality and irrational behavior. The reaction or over reaction to tapering will to some degree occur but longer term market performance will rest more with fundamentals and valuations than tapering, so lets examine what will probably be the Fed's course of action.

> "While consistent job creation of around 200,000 per month won't change the unemployment rate a great deal, it will positively impact the employment prospects for those entering the workforce."

TAPERING

The Fed has a FOMC meeting on the 17th of September, at which time they will renew their discussion or perhaps debate on when and at what pace to begin tapering away from their current purchase of securities from banks. It has always been their stated objective to withdraw from security purchases when the economy is on a sustainable growth path and balance sheets of banks were sound enough to supply the normal liquidity of commerce. The balance and liquidity goals have been achieved and now the Fed governors will have to address the sustainability forecasts. The consensus forecasts of economists is that 2013 growth will modestly accelerate in the back half of the year and sustain the 3% range growth into 2014. Recent data seems to validate these forecasts and in fact were the sequester not in more robust effect, GDP would currently be exceeding 3%. We don't think the Fed is united with respect to tapering and will at least have to consider the geopolitical instability that is dominated by Syria as well as the debt ceiling resolution that has been kicked down the road until October. The risks to initiate tapering is that it impairs the economy too soon by reducing liquidity and therefore rates rise too quickly. We don't fear this risk. We have always known the withdrawal of securities purchases will need to be artful and well executed and we expect the Fed to be and do just that. Will the markets react? Sure, but any over reaction will create opportunity. In the end, an economy robust enough to sustain itself even through the tapering process will be good for job growth, top line growth of companies and their earnings.

VALUATIONS

There are those who place a great deal of credence that the bull market that began in March of 2009 has been fueled largely by very low bond yields. Some of their reasoning is cogent but assuming that the entire run in the market as well as the sustainability of its future growth is due only to Fed-induced liquidity is wrong-headed. In the end, as well as the beginning of any bull market, valuations matter. Our return to the highs of the 2007 market as measured by the S&P 500 index doesn't mean that the market is currently over-valued. The price of stocks must be viewed by a relevant measure against their earnings and several other fundamental indicators of value. What justifies owning stocks at market highs is in large part the growth of the economy. In 1998 our entire GDP was @ ten trillion dollars. In 2008 our GDP was measured at $14 trillion, which quickly retreated to $11 trillion as a result of the Great Recession. Forecasts for 2013 suggest our GDP will be near $17 trillion and, thus, the rise in equities to near record levels must also take into consideration the growth in our economy. We have often mentioned that our bottom-up forecast of the equity market each year starts with our assumptions and forecasts for the economy. Markets tend to be fairly accurate predictors of forward periods of time. Recessions occur before we actually know we are in them and typically markets begin to sell off substantially before

"In 2008 our GDP was measured at $14 trillion, which quickly retreated to $11 trillion as a result of the Great Recession. Forecasts for 2013 suggest our GDP will be near $17 trillion..."

Commentary, continued

the recession is officially noticed. You will recall that the last quarter of 2008 was a terrible quarter for equities yet we did not know with certainty that the economy was weakening with great vigor. Conversely, the bull market began in March of 2009 well ahead of reported improvements in the pace our economic decline. September may well have some volatility but economic growth is a friend to markets. The data will tell us how the economy is performing and the equity market will, by its performance, reveal its confidence in that growth.

SYRIA

It may well be that by the time this issue of our newsletter reaches you, our country's course of action vis-à-vis Syria will be more clear. Currently a dictator is once again purported to be waging unimaginable horror against its own citizens including defenseless children and the elderly. While we are looked to by most of the western world as the enforcers of moral authority and therefore have the power to inflict punishment on Assad and his regime, we must also know that military action often leads to the unknowns and the law of unintended consequences. Why have we not sold arms to the rebel groups fighting Assad? Because identifying the good rebels is not as easy as identifying Assad as a despot dictator. The history lesson learned of arming rebels in Afghanistan fighting against the Russians in the 80's and 90's certainly helped to defeat the Russians but didn't build a nation. The vacuum left, sowed the seeds for the Taliban and Al-Qaeda. The message wasn't lost on the Russians either who have a clear memory of our arming the rebels that created Russia's "Vietnam ." We must also know that we have no moral authority in the Middle East and while we can strike with tremendous destruction of an Air Force or weapon systems, it will not be viewed by hundreds of millions of Arabs as a moral imperative but rather another war on Islam. In the end the most effective and long lasting enemies of a dictator are the citizens that the dictator represses. It isn't easy; in fact, it is always hard and very messy as is the case in Egypt today. Democracies are hard and imperfect as we ourselves have demonstrated for nearly two hundred and forty years. The future of Syria is yet to be determined and much will be revealed in the next sixty days. Markets do not like uncertainty and as long as there is uncertainty we will not see the end of market volatility. The economy is continuing its incremental growth. This will be tempered in the market place by uncertainty over tapering, the debt ceiling and Syria. September has plenty of reason to play out its tradition of being a volatile month. We will use that volatility as opportunity where warranted.

Bottom-Up and Top-Down Strategy Construction

Michael F. Odar, CFA
President

Last year we embarked on a strategic plan focused intently on improving processes and creating efficiencies so that Greenleaf team members could spend more time with and for clients. The plan, as it always has been, was constructed with input from everyone in the company. Since we just sent out the 2014 Strategic Planning Survey, I thought I would highlight our strategic planning process and its alignment with our belief that the collective wisdom of the team is greater than any one person's thoughts.

Strategy development can take many different forms. Some methods involve more of a "grass roots" approach while others strictly come from the top. Our approach is somewhat unique in that it involves a little of both. We start in early September with the annual Strategic Planning Survey and the solicitation of thoughts from everyone in the company, which this year includes someone who has only been on the team for three days. I am the only one to read the surveys and candor is certainly encouraged. The questions generally focus on a couple of different areas—how we thought we did in the previous year, mainly from our clients' perspective, and what we need to do to get better. The vast majority of improvements we have made over the years can trace their roots back to these surveys. And, consistent with our belief in the collective wisdom of the team, improvement themes typically surface in the collection of responses. Last year, Team, Improve, Processes, and Clients were the four most common words used in survey responses and thus became a primary initiative of our 2013 Strategic Plan.

Once survey themes are identified, they are vetted with members of our Executive Leadership Team (ELT) to form corporate strategic initiatives. The division leaders then begin the collaborative process of constructing plans around the corporate strategic initiatives involving members of their teams as well as members of other divisions. These plans are then brought by each divisional leadership team to our Executive Leadership Team Advance (notice I did not say "retreat") in early October. Over the course of a couple of secluded days away from the office these plans are presented, discussed, dissected, and debated through a very candid Socratic process before

"We start in early September with the annual Strategic Planning Survey and the solicitation of thoughts from everyone in the company..."

Bottom-Up and Top-Down, continued

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ultimately being approved. The outcome from the Advance is a unified strategic plan collaboratively built to address our corporate strategic initiatives with our clients' best interests in the forefront of our minds.

We then can incorporate our strategic plan into the construction of our budget for the upcoming year. This process occurs in October and again always starts with the client in mind. Once the budget is approved with the incorporated strategic plan, we brand the finalized plan and share it with the entire Greenleaf team in November at our annual Strategic Planning Meeting.

Successful strategic plans don't attempt to address everything at once and often are not wrapped up neatly over the course of a calendar year. They involve tactical moves over the course of a longer measurable timeframe. We are careful to focus our efforts on the most impactful initiatives and often build upon ongoing strategic initiatives over time. For instance, Process Improvement will continue as a foundation for future strategic plans of ours and is an easily identifiable theme so far in the 2014 Strategic Planning Survey.

If you'd like to join us in our efforts to conserve natural resources and create a greener environment, you may choose to save paper by receiving email notifications to view your statement online.
Simply give us a call at 269.388.9800 and ask to speak with a member of your client centric team.

The Antifragile IRA

Dan J. Rinzema, CFA, CFP®
Vice President
Director, Wealth Management Advisors
Asst. Director, Client Centric Team Div.

"Antifragility" is a term coined by the author, former options trader, and self-proclaimed philosopher Nassim Nicholas Taleb in his most recent book *Antifragile: Things That Gain from Disorder*. This work builds upon Taleb's prior volumes and continues to explore the true nature of risk. In *Fooled by Randomness: The Hidden Role of Chance in Life and in the Markets*, Taleb argued that we have a tendency to underestimate the role of randomness in just about everything, and we commonly mistake absence of evidence for evidence of absence as it pertains to volatility. In *The Black Swan: The Impact of the Highly Improbable*, he furthered the dialog by cataloguing our inability to understand, let alone predict, the occurrence of rare, tail-events of meaningful consequence. The term antifragility is then the logical conclusion to his prior discourse on risk. It can be thought of as simply fragility in reverse. While the fragile is harmed by shocks, volatility, uncertainty, randomness and the passage of time, the antifragile doesn't merely resist these stressors to remain the same; it gains or gets better because of them.

Wind extinguishes a candle and energizes a fire. Likewise, the central theory of *Antifragile: Things That Gain from Disorder* is that you want to use randomness, uncertainty, and volatility, not hide from them. You want to be the fire and wish for the wind. According to Taleb, the way to do this in finance, politics, and medicine is to seek the hallmark of the antifragile—asymmetric optionality. That is, situations where you have more to gain than to lose from uncertain outcomes. You want to position yourself and your portfolio to have more upside than downside when facing an increasingly uncertain world.

The ever quotable Yogi Berra once said, "In theory there is no difference between theory and practice; in practice there is." I found this to be the case as I wrestled with the concept of antifragility. While compelling in theory, I found it difficult to implement in practice. For example, application in customary investment management requires periodic outlays to dynamically hedge a portfolio with option contracts - the cost of which calls into question the overall net benefit to the investor.

When extended to investment account types, however, it struck me that the IRA can have antifragile properties. In other words, IRA's have the potential to asymmetrically benefit from market volatility, economic

"... you want to use randomness, uncertainty, and volatility, not hide from them."

Antifragile, continued

uncertainty, and fiscal shocks if you take advantage of the IRA's inherent real options. From my vantage point, these embedded options include conversion and recharacterization, qualified charitable contributions, and asset location.

Previous *Perspectives* newsletter articles have already explored qualified charitable contributions and asset location strategies as part of a robust, goals-based wealth management plan. Therefore, I will focus on how to take advantage of conversion and recharacterization as an inherent IRA option. Converting a traditional IRA, on which taxes are deferred, to a Roth IRA where eventual distributions will be tax-free, is a common strategy for investors worried about higher future tax rates. With a conversion, you pay taxes now instead of later, thereby allowing the account to benefit from the power of compounding via tax-free growth. However, a Roth IRA holder has until October of the tax year following the conversion year to recharacterize or put the money back into the traditional IRA with no taxes due.

"If the market goes awry, the option to recharacterize helps ensure investment losses don't negate the tax benefits of a prior conversion."

This represents an asymmetric real option inherent within an IRA. If the market goes awry, the option to recharacterize helps ensure investment losses don't negate the tax benefits of a prior conversion. For example, assume you convert an IRA worth $1,000,000 to a Roth IRA. Due to political or economic uncertainty mixed with the short-term volatility of the markets, your new Roth IRA sharply declines by 20% to $800,000 over the following months. Assuming you are like me and prefer lower tax bills, you will most likely decide that you do not want to pay any tax on the $1,000,000 conversion while only showing a market value of $800,000 in your Roth. You would then choose to exercise your option to recharacterize the $800,000 remaining in the Roth back to your traditional IRA as if the conversion never happened.

Better yet, you can even redo the do-over! If the value of your IRA decreases after a conversion, you can recharacterize the conversion, avoiding the tax on the original conversion, and then convert the IRA at its lower value for a lower tax bill. If you complete a recharacterization in the year following the conversion, you are free to do another Roth IRA conversion 30 days later or the following year, whichever is longer. The option to undo and redo Roth IRA conversions means the rules of the game are set up so you not only can, but should win.

While a recharacterization following a market decline is the most common reason to exercise this option, it can be used to change a contribution type, correct an error, or optimize tax brackets. To save on taxes, you may even have an opportunity to exercise this option if your income is unexpectedly lower than normal in a given year, or if you are able to control the timing of a major income event. In this sense, an IRA can benefit from randomness, uncertainty, and volatility regardless of its direction giving it antifragile properties.

While the growth of available information has been exceeded only by the expansion of noise, a comprehensive, goals-based wealth management plan can provide long term market resilience through the application of prudent planning, diversification, and asset allocation. At its core, proper planning, which provides resilience in not only today's market conditions, but also in a variety of potential future environments, is the signal that cuts through the noise. Antifragility, then, goes beyond mere resilience to gain from uncertainty. As we have seen, there are very few times in life where you can take advantage of 20/20 hindsight, but it is this embedded option that endows the IRA, in part, with the title of antifragile.

"Antifragility, then, goes beyond mere resilience to gain from uncertainty."

Steven P. Phillips
Participant Services Specialist

Is it Time to Revisit Your Fixed Income Strategy?

"… there are times when market conditions make it necessary to revisit your investment strategy. This is one of those times."

As a general rule of thumb, a "buy and hold" strategy for investing is the best way to go; however, there are times when market conditions make it necessary to revisit your investment strategy. This is one of those times. In the past five years, we have seen an extraordinary intervention by the Federal Reserve to prop up our economy and infuse liquidity into our economic system. The Fed has done this through what is known as quantitative easing. For the past five years, the Fed has been injecting money into the economy and keeping interest rates at historic lows through the purchase of Treasury securities as well as mortgage-backed securities on the open market. Let's take a brief look at what the Fed has done historically, their actions within the past five years, and what they are expected to do in the near future. Most importantly, let's evaluate how this will affect fixed income mutual funds in the years to come.

Following the bursting of the housing bubble in the United States, with the economy near the verge of collapse, the United States government intervened on an unprecedented level, using both fiscal and monetary policy to correct the situation. Banks needed liquidity and small businesses/individuals needed loans to finance homes, cars, business expansion, etc. Due to the severe lack of liquidity in the marketplace, the Fed intervened with what has come to be known as quantitative easing. From December 2008 until today, the Fed has embarked on three separate rounds of quantitative easing and purchased more than $3 trillion of Treasury securities and mortgage-backed securities. All of this has been done to prop up the economy and drive down interest rates. Since December of 2008, the Fed Funds Rate (the rate at which banks loan to one anther) has been kept between zero and 0.25% by the Fed through the use of Open Market Operations. To put this into historical perspective, the United States has never even come close to this type of monetary easing since the Federal Reserve was created in 1913. The Fed Funds rate varies based on economic conditions, but it has typically been held around 4-5%. The highest rate was 20% in 1979 and 1980 and the lowest rate was 1% in 2003.

In June, the US saw one of it's largest bond outflows in history as investors feared the free party of QE may be ending prematurely and interest rates would begin to spike. Since that time, Chairman Bernanke has calmed the financial markets and volatility has ebbed.

However, the day will eventually come when quantitative easing will end and interest rates will rise from their historic lows. Once interest rates begin to rise, bond holders may face heavy losses. The yield and the price of a bond have an inverse relationship. As interest rates rise, the value of bonds decline. The longer the duration of the bond and the higher interest rates climb, the steeper the losses.

This is why it is so important for investors to take a look at their fixed income strategy today. Many retirees or near-retirees have a majority of their portfolio in the bond market and are understandably concerned about what an interest rate hike would do to their investment returns. There are a few strategies that can be followed to avoid or reduce the potential loss associated with rising interest rates. One of those strategies has already been occurring over the past few years as investors have fled to equities to escape the low yields of the bond market. Another strategy is to shift bond investments to the shortest duration as possible. Recently, some investors also fled to cash for safety, presuming no return is better than negative returns.

There is no one-size fits all solution for bondholders looking to avoid interest rate risk. The best solution across the board is to limit the duration of the bonds that you currently hold. The longer the duration, the greater the risk you face of steep losses. A general rule of thumb states that the number of years in duration multiplied by the increase in interest rates will be the loss you may be facing on your bond. For example, say the bond fund you currently hold has a duration of 5 years. If interest rates were to increase by 1%, you would be facing a 5% loss. If your duration were 2 years, you would only be facing a 2% loss. Thus, you can see limiting duration reduces your potential for severe losses in the bond market.

There is also the strategy of shifting your investments out of the bond market and into equities or cash. Determining whether this is the best option for you requires further analysis and should be determined on a case by case basis. Your age, risk tolerance, and a host of other factors may impact this decision. Keep in mind that equities can also face steep losses and that fixed income will always play a vital role in all portfolios. Also keep in mind that investing in a cash account should be a very temporary measure. A cash account paying zero interest actually has negative returns when accounting for inflation. Finally, as interest rates begin their eventual rise, investors should continue to revisit their fixed income strategy to ensure that they have an appropriate allocation. If you have questions or would like help in determining your fixed income strategy, give Greenleaf Trust a call today.

> "In June, the US saw one of it's largest bond outflows in history as investors feared the free party of QE may be ending prematurely and interest rates would begin to spike."

Karen A. Bouche, CTFA
Executive Vice President
Trust Relationship Officer

From Generation to Generation… What Does that Mean to You?

"With the ever changing tax laws, planning for the next 3–5 years may seem daunting, let alone planning for generations that will be born after your passing!"

For some people that means passing wealth to the next generation of family members. For others it means impacting their favorite charities long after their passing. For many, it is both or something completely different. What are your ultimate goals? What do you want your wealth to accomplish? What legacy do you want to leave behind? Answers to these types of questions will help you and your team of advisors to shape your Wealth Management Plan.

With the ever changing tax laws, planning for the next 3–5 years may seem daunting, let alone planning for generations that will be born after your passing! A common and relatively simple way to complete a transfer of wealth to the next generation is through the use of an irrevocable trust. This type of transfer can occur during life or upon death of the grantor. The concept is relatively simple, you create an entity (an irrevocable trust, with its own tax i.d. number), you fund the trust with the desired assets (called property), you determine for whom (beneficiaries) and for what purpose (standards) the funds should be used and then you hand over the keys to a trustee to manage according the "rule-book" that you have drafted with your attorney.

Ideally, you will have a relationship with the trustee and the trustee will not only understand your intentions, but is qualified and knowledgeable in fiduciary requirements, asset management and trust administration. Of course, I believe that Greenleaf Trust as a corporate trustee is uniquely positioned and qualified to serve in this capacity. So, you have created an irrevocable trust, it is funded and you have selected a trustee to manage the assets on behalf of the beneficiaries and eventually make distributions to the beneficiaries. You're off and running with no worries, right? Well…maybe.

Naturally, life changes and circumstances evolve over time. The irrevocable terms that you drafted with one set of circumstances may not exactly apply any longer. You may not have been able to anticipate the world in which the trustee is now operating within. For example, what happens if you've allowed for the trust to fund education expenses for your children's children and they have none? What happens if you've stipulated that the funds are to be used for education, but then a beneficiary has a serious illness that requires significant funds? What if your desired beneficiaries change and you wish to include others that are not bloodline relatives or exclude some that are? While impossible to draft for all of the "what-ifs", providing the trustee with some flexibility, or "discretion", to keep pace with the future unknowns may make sense. A well drafted document will do just that, so be sure to work with a qualified attorney!

My experience in talking with individuals with wealth is that transferring assets is seldom their number one priority. More commonly, it is the intangible wealth that they wish to pass on: knowledge of the financial industry, confidence in managing their own finances, awareness of the impact wealth can have on the lives of others, personal beliefs of the responsibilities of those with wealth or other personal values. For this purpose, an irrevocable trust can certainly be one component; the beneficiaries will learn the mechanics of how a trust works and will likely work with a professional team who will teach them along the way. However, another vehicle that can be used to accomplish the transfer of intangible wealth is a private non-operating foundation. Similar to a trust, a foundation can be established, accept assets and then distribute funds to charities in accordance with the foundation's mission.

Funding a private non-operating foundation is a serious commitment, both in dedication of time and of financial resources. As such it is not appropriate for all. Wealthy individuals or families that have committed to funding a foundation during life often involve the next generation, and eventually future generations, or others near and dear to them through a Board of Directors structure. This creates a forum for gatherings and dialogue, discussion of what impact they want to have collectively, all while benefiting others and learning along the way. Often times, the foundation will become the beneficiary of other assets upon death, ultimately funding it to a larger extent allowing those involved to continue the legacy for many years to come. Much like the trustee having discretion over an irrevocable trust, the board of a foundation can and typically will continually evaluate how to best carry out the intent of the grantors.

Wealth is defined very differently by different people. Whether it is an investment portfolio, physical property, family traditions, knowledge or values, there are ways in which we can help our clients pass their wealth on from generation to generation. What do you want your wealth to accomplish for you? Your client centric team can help structure a plan to get you there!

"Wealth is defined very differently by different people... What do you want your wealth to accomplish for you?"

Josh D. Wheeler, CFA
Research Analyst

Our Stock Selection Process

Our process for selecting new stocks for our Focus List at Greenleaf Trust starts with each analyst sifting through his universe of "names" (stocks) to narrow them down to a few to bring to the broader investment committee made up of the Director of Research, the Research Analysts and the Mutual Fund Analyst. The sifting-through-the-universe process is ongoing as opposed to a discrete, point-in-time event, given the analysts are constantly monitoring their respective sectors.

Each of the analysts who cover stocks for Greenleaf Trust focuses on a few sectors (e.g., technology, materials, industrials, etc.) so he can build expertise in these areas. In some instances, the analysts have background or experience in these sectors so that they bring that knowledge to bear on the stock selection process. Our sector assignment approach contrasts with the "generalist" approach used by some firms, where each analyst is free to pick stocks out of the entire equity universe. Both have merits and vulnerabilities, but we feel the sector-specific approach is the best fit for our team at Greenleaf.

"Each of the analysts who cover stocks for Greenleaf Trust focuses on a few sectors (e.g., technology, materials, industrials, etc.) so he can build expertise in these areas."

The analysts sift through their respective sectors in a number of ways. One method is to run a quantitative screen. Using financial software, we input parameters based on our Four-Pillar Test, which is our equity selection framework that we use to find good companies (attractive businesses model with strong free cash flow generation and a management team that stewards capital well) at attractive prices.

In addition to screens, our analysts do a lot of reading – from industry reports, to daily news publications to SEC filings from companies we own or follow – and we get ideas this way. Occasionally, when reading through a report of one of the companies we cover or talking to its management team, we'll learn about a competitor or supplier that we hadn't heard of or didn't know much about, and this will generate an idea. We also read commentaries from successful investors in the industry who will discuss their own ideas, and this can be a good source. There is nothing wrong with recognizing and leveraging somebody else's good idea as long as it fits our criteria. Finally, because we each have years of experience covering companies, we are aware of many of the companies in our sectors to the point where we can get up to speed on them pretty quickly if an event happens such that their story or valuation becomes more interesting.

After the analyst has narrowed the list down to one or two names, he'll bring it to the investment committee at an initial stage, which may contain a short memo and a simple valuation model. The purpose of this stage is to take the temperature of the committee to see if the idea has potential before the analyst does the bulk of the work. During this preliminary discussion and with the benefit of multiple viewpoints around the table, significant risks may be raised that are "deal-breakers," and the idea may stop right there. If the committee's consensus is that the idea has merit, the analyst will go back and do a deep dive on the name, which would include an in-depth analysis based on the Four-Pillar Test and a comprehensive valuation model. The analyst then provides a full report to the committee, the committee has a discussion, and a vote can be taken then or the committee can ask the analyst to go back and research a few specific issues. At that point the committee will vote up or down, and if it is a yes vote, the name will be added to the Focus List and generally purchased right away at a 2% or 3% weight, depending on conviction level and valuation. On some occasions we wait for a better price before buying the initial position. The whole process from screening to purchase can take a few weeks up to several months.

Each committee member brings different backgrounds, experiences and lessons learned from mistakes. Discussions around the table can get heated, and that's how we want it. Everyone knows that nothing said during the research meeting should be taken personally, but it's important to push hard on the arguments being made by the covering analyst. If we're looking at a stock, it's probably not firing on all cylinders—otherwise, why would a good company be attractively priced? So it's critical to make sure that the thesis or reasoning behind why we think the market is being overly pessimistic is sound. The market is not perfectly efficient but it's usually pretty smart.

The strength of this process is the expertise and deep research of the analysts combined with the perspective of the committee, and we think it best positions our clients to maximize their equity returns while minimizing risk over the long term.

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Stock Market Pulse

Index	8/31/13	Total Return Since 12/31/2012
S&P 1500	378.67	16.41%
DJIA	14,810.31	14.97%
NASDAQ	3,589.87	19.95%
S&P 500	1,632.97	16.15%
S&P 400	1,183.87	17.13%
S&P 600	572.82	21.12%
NYSE Composite	9,270.66	9.80%
Dow Jones Utilities	477.87	8.33%
Barclays Aggregate Bond	106.21	-3.08%

P/E Multiples	8/31/13
S&P 1500	15.2x
DJIA	14.2x
NASDAQ	17.6x
S&P 500	14.8x
S&P 400	18.9x
S&P 600	20.0x

Key Rates

Fed Funds Rate	0% to 0.25%
T Bill 90 Days	0.02%
T Bond 30 Yr	3.68%
Prime Rate	3.25%

Current Valuations

Index	Aggregate	P/E	Div. Yield
S&P 1500	378.67	15.2x	2.08%
S&P 500	1,632.97	14.8x	2.18%
DJIA	14,810.31	14.2x	2.44%
Dow Jones Utilities	477.87	NA	4.10%

Spread Between 30 Year Government Yields and Market Dividend Yields: 1.59%

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